DEPARTMENT OF STATE REVENUE

LETTER OF FINDINGS NUMBER: 98-0523

CORPORATE INCOME TAX

FOR TAX PERIODS: 1993-1994

NOTICE: Under IC 4-22-7-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register. The publication of this document will provide the general public with information about the Department's official position concerning a specific issue.

Issue

1. Adjusted Gross Income Tax: Business Income

Authority: 26 USC Sec.338(h)(10), 26 USC 338(h)(10), IC 6-3-1-20, 45 IAC 3.1-1-29, 45 IAC 3.1-1-30, The May Department Store Company v. Indiana Department of State Revenue, 749 N.E.2d 651 (Ind. Tax 2001).

The taxpayer protests the classification of certain income as business income.

Statement of Facts

The taxpayer is an out-of-state-corporation engaged in sales of goods and services in Indiana and several other states. After an audit, the Indiana Department of Revenue, ("department"), assessed the taxpayer additional corporate income taxes. The taxpayer protested the assessment and a hearing was held. More facts will be provided as necessary.

1. Adjusted Gross Income Tax: Business Income

Discussion

In 1994, Corporation A ("actual buyer"), an unrelated taxpayer, acquired the stock of Corporation B, the parent corporation of the taxpayer and a wholly owned subsidiary of Corporation C ("actual seller"). Actual buyer and actual seller entered into a joint federal income tax election under 26 USC Sec.338(h)(10) which allowed the buyer and seller to treat the sale of stock of corporation B as a sale of the assets of corporation B and its subsidiaries for income tax purposes. Under the provisions of 26 USC 338(h)(10), The taxpayer was deemed to have sold all of its assets to the "new target" on the date of acquisition and immediately distribute the proceeds from the deemed asset sale to its parent corporation in complete liquidation. The taxpayer protested the department's recharacterization of this income as business income subject to Indiana taxes.

In The May Department Store Company v. Indiana Department of State Revenue, 749 N.E.2d 651 (Ind. Tax 2001), the Indiana Tax Court determined that IC 6-3-1-20 provides for both a transactional test and a functional test in determining whether income is business or non-business in nature. Id. at 662-3.

The court looks to 45 IAC 3.1-1-29 and 30 for guidance in determining whether income is business or non-business income under the transactional test. These regulations state ". . . the critical element in determining whether income is 'business income' or 'non-business income' is the identification of the transactions and activity which are the elements of a particular trade or business." Id. at 664. 45 IAC 3.1-1-30 lists several factors in making this determination. These include the nature of the taxpayer's trade or business; substantiality of the income derived from activities and relationship of income derived from activities to overall activities; frequency, number or continuity of the activities and transactions; length of time income producing property was owned; and taxpayer's purpose in acquiring and holding the property producing income. In May, the Court found that the transactional test was not met when a retailer sold a retailing division to a competitor because it was an extraordinary and nonrecurring transaction for the taxpayer. Id. at 664.

The nature of this taxpayer's business included various aspects of the food service business. Almost all of the taxpayer's income derived from transactions associated with these activities. The deemed sale of assets was an extraordinary and nonrecurring transaction for the taxpayer. Therefore, it did not meet the transactional test for classification as business income.

The functional test focuses on the property being disposed of by the taxpayer. Id. at 664. Specifically the functional test requires examining the relationship of the property at issue with the business operations of the taxpayer. Id. at 664. In order to satisfy the functional test the property generating income must have been acquired, managed and disposed of by the taxpayer in a process integral to taxpayer's regular trade or business operations. Id. at 664. The Court in May defined "integral" as part or constituent component necessary or essential to complete the whole. Id. at 664-5. The Court held that the May's sale of one of its retailing division was not "necessary or essential" to May's regular trade or business because the sale was executed pursuant to a court order that benefited a competitor and not May. In essence, the Court determined that because May was forced to sell the division in order to reduce its competitive advantage, the sale could not be integral to May's business operations. Therefore, the proceeds from the sale were not business income under the functional test.

In the taxpayer's situation, the taxpayer disposed of a business selling food. At the taxpayer's election, the funds from the sale were funneled into a related corporation's business selling food. The business decision was made to acquire, manage and dispose of the income to further the corporation's function. Therefore, this sale meets the functional test for classification as business income.

Finding

The taxpayer's protest is denied.

KA/JM/MR--022208